



Discussion Paper No. 2002/53

Unsustainable Debt Burden and Poverty in Pakistan

A Case for Enhanced HIPC Initiative

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Abstract

The financing of Pakistan's substantial current account deficits within the framework of IMF and the World Bank structural adjustment programmes—about 6 per cent of GDP in the early 1990s led to a debt crisis in the late 1990s. IMF considered this level of current account deficit quite feasible in order to allow import liberalization, while the country needed both internal as well as the external adjustment. IMF also frequently demanded devaluation of the rupee against the US dollar to enhance exports. While exports remained stagnant, the devaluation has directly added to the rupee value of foreign debt resulting in a dramatic increase in debt service burden leading to debt crisis, lower economic growth and higher poverty level in 1998. While devaluation was supposed to boost exports and stimulate economic growth, it seems to have had a recessionary impact on the economy by raising the cost of imported intermediate inputs.

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Keywords: debt, adjustment, poverty, liberalization

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Thus, devaluation as an instrument for export promotion involves substantial costs while its benefits are uncertain. Pakistan's external debt as per cent of GNP is now higher than all but the heavily indebted poor countries (HIPCs); its total debt service as per cent of exports is considerably higher than all the countries, including the HIPCs, a reflection of the country's grave debt crisis. Although Pakistan qualifies for assistance under the enhanced HIPC Initiative as per criterion of NPV of debt to exports, it has to strive to meet other eligibility criteria. This criteria should be revised to broaden the debt relief to countries whose debt problems are much severe than the HIPC countries. Countries like Pakistan with poverty reduction strategies should be entitled to immediate debt relief. For effective debt management, fiscal consolidation, including tax reform to strengthen the fiscal payments capacity, is essential in achieving debt sustainability. Attention should be given to eliminating the dependence on a very narrow production and export base.

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1 Introduction

Like many other developing countries, Pakistan has also resorted to borrowing heavily from foreign and domestic sources to finance its development plans, consequently maintaining large fiscal deficits in past which became unsustainable in the late 1980s. Heavy reliance on borrowings to finance fiscal as well as the current account deficits led to an accumulation of debt, which grew from about Rs 155 billion in 1980s to Rs 802 billion in the 1990s. Total debt has almost doubled over the last five-year period and now in 1999-2000 stands at Rs 3,095.5 billion. As a result, the ratio of total debt to GDP escalated from 88.5 per cent in 1995/6 to 97.5 per cent in 1999-2000.

Sustainability of external debt is closely related to external current account sustainability. An examination of external debt burden in relation to current account indicators shows that its sustainability is seriously affected over the last five years. Stagnant export and foreign exchange earnings, together with heavy reliance on foreign resources, were the main contributory factors in worsening the external debt indicators. The ratio of external debt to exports earning deteriorated to 277 per cent over the last five years—a level beyond the critical threshold of debt sustainability.

The paper examines the unsustainable debt burden and its impact upon poverty in Pakistan. The organization of the paper is as follows: section 2 discusses the external debt burden of Pakistan. Section 3 compares Pakistan's debt burden with the other developing countries including the heavily indebted poor countries. Section 4 investigates the causes of Pakistan's debt crisis. Section 5 focuses on the revival of economic growth and debt reduction, and section 6 discusses the enhanced HIPC's Initiative and Pakistan's eligibility for debt relief under the Initiative. Finally, section 7 draws some conclusions from the analysis.

2 External debt burden

Pakistan's external debt is defined as the total debt that resident public and private entities in the country contracted from nonresidents on a well-defined repayment structure. It comprised of (i) public and publicly guaranteed debt; (ii) private non-guaranteed credits; (iii) central bank deposits; and (iv) IMF loans. On the other hand, foreign exchange liabilities are primarily held by residents with no structured repayment schedule. In US dollar terms, Pakistan's external debt amounted to 34.2 billion or 53.8 per cent of GDP at the end of 1999-2000 fiscal year (Table 1). Adding foreign exchange liabilities of US\$ 4.5 billion to the external debt, the total external liabilities will rise to US\$ 38.8 billion or 61 per cent of GDP. While external debt increased by 12 per cent over the last five years, foreign exchange liabilities declined substantially by 36 per cent, mainly due to a reduction in the stock of foreign currency accounts.

The external debt which has surpassed the domestic debt in 1995/6, increased¹ rapidly by Rs 560.8 billion or 57 per cent to Rs 1,536.7 billion between 1995/6 and 1999/2000. While external debt in dollar terms grew by 12 per cent, the phenomenal growth of 57 per cent in rupee terms was attributed to the 11 per cent average annual depreciation of the rupee against the US dollar demanded by the IMF to enhance exports over the last five years. While export remained stagnant, mainly due to weak commodity prices and

¹ See State Bank of Pakistan, Annual Report 2000

non-availability of exportable surplus, debt burden became unsustainable, resulting in rescheduling in 1998-99.

Public and publicly guaranteed debt has been the dominant kind of external debt in Pakistan for many decades. At fiscal year 1999/2000 (fiscal year 2000), it accounted for 85 per cent of total external debt (Table 2). However, the 1990s observed a significant change in the composition of external debt as the share of private non-guaranteed debt rose rapidly from 4.83 per cent in fiscal year 1995 to 10.45 per cent in fiscal year 1999. Since a large share of public and publicly guaranteed external debt owed to official creditors, the country's external debt is typically long term, when classified by original maturity. The 1990s witnessed a profound change in the composition of external debt. The share of short- and medium-term external debt rose sharply from 10.7 per cent at end 1990/1 to 22.1 per cent at end 1998/9 (Table 3). This accounts for the large increase in total external debt between 1992/3 and 1998/9; notably the short-term debt and external liabilities forced the country for rescheduling in 1998/9.

Table 1
Pakistan's external liabilities (US\$ millions)

| | FY 1995 | FY 1996 | FY 1997 | FY 1998 | FY 1999 | FY 2000 |
|--|----------------------------------|---------|---------|---------|---------|---------|
| I. Public and publicly guaranteed debt | 26,228 | 26,501 | 27,182 | 27,088 | 26,904 | 29,179 |
| A. Medium and long term (>1 year) | 25,976 | 25,977 | 26,510 | 26,536 | 26,486 | 28,618 |
| B. Short-term (• 1 year) | 252 | 524 | 672 | 552 | 418 | 561 |
| II. Private non-guaranteed debts | 1,418 | 2,405 | 2,705 | 3,127 | 3,435 | 2,842 |
| III. Central bank deposits | 88 | 0 | 150 | 450 | 700 | 700 |
| IV. IMF | 1,630 | 1,535 | 1,316 | 1,415 | 1,825 | 1,550 |
| Total external debt | 29,364 | 30,441 | 31,353 | 32,080 | 32,864 | 34,271 |
| V. Foreign exchange liabilities | 7,764 | 9,299 | 11,011 | 1,760 | 4,315 | 4,587 |
| Foreign currency accounts | 6,575 | 8,305 | 9,844 | 1,507 | 2,269 | 2,349 |
| FCAs prior to freeze | 5,376 | 6,297 | 7,646 | Frozen | | |
| FE-45 | 1,199 | 2,008 | 2,198 | 1,507 | 1,380 | 1,072 |
| FE-25 Deposits | 0 | 0 | 0 | 0 | 617 | 977 |
| Outside SBP | 0 | 0 | 0 | 0 | 550 | 616 |
| With SBP (FE 13) | 0 | 0 | 0 | 0 | 67 | 361 |
| FE-31 Deposits (incremental) | 0 | 0 | 0 | 0 | 272 | 300 |
| Special US dollar bonds | 0 | 0 | 0 | 0 | 1,164 | 1,297 |
| National debt retirement programme | 0 | 0 | 0 | 0 | 225 | 185 |
| Others liabilities | 600 | 500 | 753 | 253 | 657 | 756 |
| FEBC | 434 | 339 | 260 | Frozen | | |
| FCBC | 132 | 147 | 149 | | | |
| DBC | 23 | 8 | 5 | | | |
| Total external liabilities (I to V) | 37,128 | 39,740 | 42,364 | 33,840 | 37,179 | 38,858 |
| External liabilities payable in rupees | See foreign exchange liabilities | | | 8,500 | 3,391 | 1,720 |
| Frozen FCAs | | | | 8,172 | 3,196 | 1,572 |
| FEBC | | | | 193 | 129 | 109 |
| FCBC | | | | 131 | 63 | 36 |
| DBC | | | | 4 | 3 | 3 |

Source: Statistics Department, State Bank of Pakistan.

Table 2
Structure of external debt, Fiscal years 1995-2000 (% of total external debt)

| | FY 1995 | FY 1996 | FY 1997 | FY 1998 | FY 1999 | FY 2000 |
|--|---------|---------|---------|---------|---------|---------|
| I. Public and publicly guaranteed debt | 89.32 | 87.06 | 86.70 | 84.44 | 81.86 | 85.14 |
| A. Medium and long term (> 1 year) | 88.46 | 85.34 | 84.55 | 82.72 | 80.59 | 83.51 |
| B. Short-term (• 1 year) | 0.86 | 1.72 | 2.14 | 1.72 | 1.27 | 1.64 |
| II. Private non-guaranteed debts | 4.83 | 7.90 | 8.63 | 9.75 | 10.45 | 8.29 |
| III. Central bank deposits | 0.30 | 0.00 | 0.48 | 1.40 | 2.13 | 2.04 |
| IV. IMF | 5.55 | 5.04 | 4.20 | 4.41 | 5.55 | 4.52 |
| Total external debt | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Statistics Department, State Bank of Pakistan.

Table 3
Outstanding external debt and its growth
(US\$ millions)

| | External debt | | | Growth rates | | |
|---------|------------------|-------------------|--------|--------------|-------------------|-------|
| | Long term | Short/medium term | Total | Long term | Short/medium term | Total |
| 1990/1 | 15,471 (89.3) | 1,856 (10.7) | 17,327 | | | |
| 1991/2 | 17,361 (89.4) | 2,057 (10.6) | 19,418 | 12.2 | 10.8 | 12.1 |
| 1992/3 | 19,044 (87.2) | 2,800 (12.8) | 21,844 | 9.7 | 36.1 | 12.5 |
| 1993/4 | 20,322 (83.1) | 4,139 (16.9) | 24,461 | 6.7 | 47.8 | 12.0 |
| FY 1995 | 22,117 (83.4) | 4,409 (16.6) | 26,526 | 8.8 | 6.5 | 8.4 |
| FY 1996 | 22,275 (80.3) | 5,460 (19.7) | 27,735 | 0.7 | 23.8 | 4.6 |
| FY 1997 | 23,145 (81.8) | 5,140 (18.2) | 28,285 | 3.9 | -5.9 | 2.0 |
| FY 1998 | 23,042 (79.5) | 5,940 (20.5) | 28,982 | -0.4 | 15.6 | 2.5 |
| FY 1999 | 23,101 (77.9) | 6,572 (22.1) | 29,673 | 0.3 | 10.6 | 2.4 |
| FY 1900 | 23,834 (80.9) | 5,622 (19.1) | 29,456 | 3.2 | -14.5 | -0.7 |

Note: Figures in parentheses represent percentage shares in total.

Source: Statistics Department, State Bank of Pakistan.

Although the share of short- and medium-term external debt remained less than 20 per cent of total external debt between 1990/1 to 1997/8, external debt were large enough to contribute to external financial vulnerability, as the official foreign exchange reserves

remained low during this period (Table 3). In addition, with increasing amounts of scheduled debt service payments falling the next 12 months on long-and medium-term public and private debt, the effective short-term debt rose rapidly, a fact which contributed further to external the financial vulnerability of the economy resulting in rescheduling in the late 1990s.

2.1 The debt service burden

External debt sustainability is concerned with the capacity of the borrowing country to service its debt under conditions of respectable economic growth and macroeconomic stability. However, these two conditions were nonexistent in Pakistan in the 1990s. As a result, there was a dramatic increase in debt service burden of external debt. While foreign exchange earning fluctuated around US\$ 11-12 billion between 1995 and 2000, the debt service burden (due before debt rescheduling) rose rapidly. As a result, debt service to foreign exchange earning rose sharply from 27.5 per cent in 1994/5 to 41.4 per cent in 1997/8.

3 Cross-country comparison of Pakistan's debt burden

A cross-country comparison of Pakistan's debt burden is given in Table 4. The indebtedness of selected Countries is compared as per cent of GNP and of exports to reflect potential capacity to service debt. To take an account of the concessional element of external borrowing, a comparison has also made in terms of the net present value of external debt obligations which uses the appropriate rates of discount. The results of the comparison are as follow:

- Pakistan's external debt as per cent of GNP was clearly higher than all but the heavily indebted countries in 1998. It was more than twice that of India and Bangladesh and considerably higher than the average of low-income and developing countries. The net present value of external debt as per cent of GNP follows the same ranking;
- Pakistan's external debt as per cent of exports was also clearly higher than all but the heavily indebted countries. The net present value of external debt as per cent of exports follows the same pattern;
- Pakistan's total debt service as per cent of exports is considerably higher than all countries including the heavily indebted countries, which reflects the gravity of the country's debt crisis. In 1998, its interest payment on external debt as per cent of exports was 8 per cent compared with 7.4 per cent, and 5.4 per cent in low-income and heavily indebted countries, respectively.

The above comparison shows that Pakistan's debt crisis is largely attributed to the heavy external debt service burden. An interesting point to note is that although Pakistan's debt service burden was higher than in most countries, debt stock ratios were, in fact, significantly lower than the heavily indebted countries. This reflects the country's non-concessional public and private debt with shorter maturities and higher interest rate relative to the heavily indebted countries. The less favorable debt structure

in Pakistan is also evident from the fact that in 1997, the average grant element² in the debt of low-income countries was about 44 per cent, while it was only 21 per cent in Pakistan. Likewise, the average maturity of Pakistan's external debt was only 12 years compared to an average of 25 years in low-income countries.

Table 4
Indebtedness indicators

| | External debt to export ratio | NPV of external debt to export ratio | External debt to GNP ratio | NPV of external debt to GNP ratio | Total external debt service to export ratio | Interest payment to export ratio |
|--------------------|-------------------------------------|--|----------------------------------|--|--|--|
| South Asia | | | | | | |
| India | 172 | 147 | 24 | 20 | 21 | – |
| Bangladesh | 245 | 151 | 38 | 24 | 10 | 3 |
| Sri Lanka | 132 | 97 | 58 | 43 | 7 | 2 |
| Pakistan | 277 | 230 | 53 | 42 | 24 | 8 |
| Developing country | 146 | 133 | 17.6 | 38 | 20 | 7.4 |
| Low-income country | 273 | – | 47.9 | – | 17.8 | 7.4 |
| HIPCs | 386 | 249 | 121.5 | 84 | 13.9 | 5.4 |

Note: World Bank (2000a) understates the debt burden for Pakistan as it excludes some short-term external debt. Including all such kind of debt, the external debt-to-export ratio comes to 400 per cent for 1999-00, which is clearly higher than all country groups in the world.

Source: World Bank (2000a).

4 Causes of debt crisis

The financing of Pakistan's substantial current account deficits in the early 1990s sowed the seeds for its future debt problems. The current account deficit in the period 1990-99 was over US\$ 25 billion or an average of 4.8 per cent of GDP. Treating resident foreign currency deposits (RFCD) as borrowing rather than earnings, the cumulative current account deficit during the above period was US\$ 32 billion, or over 6 per cent of GDP, a level not sustainable even with a very rapid growth of exports. Thus, the likelihood of crisis was certain. However, IMF considered³ this level of current account deficit quite viable for 1997/8. In fact, it was manifested in the IMF structural adjustment programmes by putting too much emphasis on fiscal adjustment through demanding management policies and ignoring the need to adjust external account deficit in order to allow import liberalization in the country. The country needed both external and internal adjustment during the last decade. The large current account deficit was financed through foreign currency deposits and foreign investment in the energy sector with guaranteed price for electricity sale, while the consequences of such financing on the long-term balance of payment were mainly ignored. In addition, IMF frequently demanded devaluation of the rupee against the US dollar to enhance exports. Exports remained stagnant, and the devaluation has directly added to the rupee value of foreign debt, resulting in the dramatic increase in debt service burden that led to the debt crisis in 1998.

² World Bank (2000a).

³ Government of Pakistan (2001).

Table 5
Foreign trade statistics, 1972/3 to 1999-2000

| Year | Exports | Imports | Exchange rate (% change) | Exports | Imports | Overall trade | Trade deficit | A/C deficit | Exports | Imports |
|-----------------------|-----------------|---------|--------------------------------|-------------|---------|------------------|------------------|-------------|--------------|---------|
| | (US\$ millions) | | Rs/US\$ | As % of GDP | | | | | Growth rates | |
| 1972/3 | 766 | 891 | | 8.2 | 9.6 | 17.8 | 1.3 | 1.1 | | |
| 1973/4 | 1020 | 1493 | 15.4 | 11.4 | 16.6 | 28.0 | 5.3 | 5.4 | 33.2 | 67.6 |
| 1974/5 | 978 | 2114 | -1.2 | 8.6 | 18.7 | 27.3 | 10.0 | 9.4 | -4.1 | 41.6 |
| 1975/6 | 1162 | 2139 | 0.0 | 8.8 | 16.1 | 24.9 | 7.4 | 6.2 | 18.8 | 1.2 |
| 1976/7 | 1132 | 2418 | 0.1 | 7.4 | 15.9 | 23.3 | 8.4 | 5.9 | -2.6 | 13.0 |
| 1977/8 | 1283 | 2751 | 0.0 | 7.1 | 15.3 | 22.4 | 8.2 | 2.7 | 13.3 | 13.8 |
| 1978/9 | 1644 | 3816 | 0.0 | 8.3 | 19.2 | 27.5 | 11.0 | 5.0 | 28.1 | 38.7 |
| 1979/80 | 2341 | 4857 | 0.0 | 9.9 | 20.5 | 30.4 | 10.6 | 3.7 | 42.4 | 27.3 |
| 1980/1 | 2799 | 5563 | -0.1 | 10.3 | 20.4 | 30.7 | 10.1 | 2.8 | 19.6 | 14.5 |
| 1981/2 | 2319 | 5769 | 0.1 | 7.1 | 17.6 | 24.7 | 10.5 | 3.4 | -17.1 | 3.7 |
| 1982/3 | 2627 | 5616 | 28.2 | 9.2 | 19.6 | 28.8 | 10.4 | 0.6 | 13.3 | -2.7 |
| 1983/4 | 2669 | 5993 | 6.1 | 8.6 | 19.2 | 27.8 | 10.7 | 2.2 | 1.6 | 6.7 |
| 1984/5 | 2457 | 6009 | 12.4 | 7.9 | 19.3 | 27.2 | 11.4 | 4.1 | -7.9 | 0.3 |
| 1985/6 | 2942 | 5984 | 6.5 | 9.2 | 18.8 | 28.0 | 9.5 | 2.4 | 19.7 | -0.4 |
| 1986/7 | 3498 | 5792 | 6.4 | 10.5 | 17.4 | 27.9 | 6.9 | 1.0 | 18.9 | -3.2 |
| 1987/8 | 4362 | 6919 | 2.4 | 11.4 | 18.0 | 29.4 | 6.7 | 3.1 | 24.7 | 19.5 |
| 1988/9 | 4634 | 7207 | 9.2 | 11.6 | 18.0 | 29.6 | 6.4 | 3.4 | 6.2 | 4.2 |
| 1989/90 | 4926 | 7411 | 11.6 | 12.3 | 18.6 | 30.9 | 6.2 | 3.4 | 6.3 | 2.8 |
| 1990/1 | 5902 | 8385 | 4.6 | 13.0 | 18.4 | 31.4 | 5.5 | 3.0 | 19.8 | 13.1 |
| 1991/2 | 6762 | 8998 | 10.8 | 13.9 | 18.5 | 32.4 | 4.6 | 1.9 | 14.6 | 7.3 |
| 1992/3 | 6785 | 10049 | 4.5 | 13.1 | 19.4 | 32.5 | 6.3 | 6.4 | 0.3 | 11.7 |
| 1993/4 | 6685 | 8685 | 16.2 | 12.8 | 16.7 | 29.5 | 3.8 | 3.2 | -1.5 | -13.6 |
| 1994/5 | 7759 | 10296 | 2.3 | 12.7 | 16.9 | 29.6 | 4.2 | 3.5 | 16.1 | 18.5 |
| 1995/6 | 8311 | 12015 | 8.8 | 13.0 | 18.8 | 31.8 | 5.8 | 6.8 | 7.1 | 16.7 |
| 1996/7 | 8096 | 11241 | 16.2 | 12.8 | 17.8 | 30.6 | 5.0 | 5.6 | -2.6 | -6.4 |
| 1997/8 | 8434 | 10301 | 10.8 | 13.3 | 16.3 | 29.6 | 2.9 | 2.7 | 4.2 | -8.4 |
| 1998/9 | 7570 | 9344 | 16.1 | 12.5 | 15.5 | 28.0 | 2.9 | 2.6 | -10.2 | -9.3 |
| 1999/2000* | 8488 | 10033 | 3.2 | 13.3 | 15.7 | 29.0 | 2.6 | 2.3 | 12.1 | 7.4 |
| Decade average, 1970s | | | 1.8 | 9.0 | 17.8 | 26.8 | 8.9 | 5.1 | 18.6 | 27.2 |
| Decade average, 1980s | | | 8.8 | 10.1 | 18.5 | 28.6 | 8.4 | 2.7 | 8.5 | 4.4 |
| Decade average, 1990s | | | 9.9 | 13.0 | 17.3 | 30.3 | 4.2 | 3.9 | 4.5 | 2.7 |

Note: * Projected by the SBP.

Source: State Bank of Pakistan Annual Reports.

Ironically, in the late 1980s, the current account deficit of 4 per cent of GDP that the country faced as a result of the declining demand for its exports because of the recession in the industrial countries was considered quite unsustainable by the IMF. It is noteworthy that in the late 1980s, the main source of deterioration in the current account deficit was external, while in the 1990s it was internal, as the country was spending beyond its means as result of import liberalization. However, since the late 1980s external assistance was sought from the IMF and the World Bank to reduce the current

account deficit, which they provided by formulating structural adjustment programmes and placing policy conditionalities in these programmes. Along with many other policy reforms, devaluation and trade liberalization have been the most important components of adjustment programmes during the 1990s. These two major policy reforms have turned out to be highly controversial not only in Pakistan but also in many other developing countries. It is, therefore, important to examine the effects of these reforms on the economy.

IMF argues that devaluation is a powerful tool for restructuring relative prices and incentives. Devaluation raises the price of tradables and lowers the price of non-tradables, and is expected to produce a contraction of imports and expansion of exports, which is likely to improve the trade deficit. But the efficacy of devaluation depends on the export supply and import demand elasticities. A sum of the elasticities greater than one will bring an equilibrium in the trade balance. However, experience has shown that these elasticities remained low in Pakistan as the economy is structurally import-dependent, and export expansion needs more time and investment than demonstrated by the proponents of devaluation. Hence, with low price and income elasticities for Pakistan's exports, devaluation led to reduced foreign currency earnings and thus reduced level of investment, which constrained future foreign currency earning capacity. Devaluation of the rupee also increased the price of imported raw material as well as machinery, which added to the production costs of non-tradable goods and pushed up the price of domestically consumed goods. This eroded the anticipated gain in the competitiveness of exports, again calling for another devaluation to improve export competitiveness. Thus, each devaluation episode is ensued by inflation, and the vicious circle of devaluation and inflation has not only worsened the trade balance but has also resulted in an unsustainable debt burden and higher cost of external debt servicing over the last decade.

Devaluation was supposed to restore export competitiveness and stimulate growth. Instead, devaluation seems to have had a recessionary impact on the economy and resulted in lower economic growth rate in 1990s than the 1980s (Table 8). In fact, by raising the cost of imported intermediate inputs, the persistent devaluation of the rupee against the dollar has had adverse supply effect. Alternatively, when devaluation is accompanied by a rise in the domestic price level, as is often the case in Pakistan, it erodes the purchasing power of money, which through a 'real balance effect' leads to a decline in aggregate demand and thus ensue recession.

In addition, the country also pursued import liberalization within the framework of IMF and the World Bank. Maximum tariff rates were brought down from 225 per cent in 1988 to 70 per cent in 1994/5, to 45 per cent in 1997, and finally to 35 per cent in 1998/9. In addition, domestic interest rates were liberalized and, as discussed above, the rupee was devalued persistently to improve competitiveness of its exports. The lowering of tariffs reduced the protection of the domestic industry, while liberalization of domestic interest rates, together with the persistent round of depreciations, increased domestic production costs. Consequently, growth of large-scale manufacturing remained weak after liberalization and became negative in 1996/7, which resulted in a higher loan default in the financial sector. As a result, in the country there are now approximately 4,000 weak industrial units and Rs 263 billion as non-performing loans (about 28 per cent of total advances).

Table 6
Fiscal indicators as per cent of GDP, 1979/80 to 1999/2000

| | | Revenue collection as percentage of GDP | | | | | | | | | | Expenditure as percentage of GDP | | | | | | | | | |
|---------------|---------|---|------|----------------|--------|-------|---------|-----------|-------|---------|---------------------|----------------------------------|-------|-----------|----------------|---------|--------------|----------------|-------|-------------|-----|
| | | Taxes | | Indirect taxes | | | | | | | Current expenditure | | | | | | | | | | |
| | | | | Total indirect | Excise | Sales | Customs | Surcharge | Other | Non-tax | Budget deficit | Total expenditure | Total | Deference | Debt servicing | Subsidy | General adm. | Socio-economic | Other | Development | |
| Total revenue | Rev. | Direct | | | | | | | | | | | | | | | | | | | |
| 8 | 1979/80 | 16.4 | 13.9 | 2.2 | 11.8 | 4.5 | 1.0 | 5.4 | 0.3 | 0.7 | 2.6 | 6.8 | 23.2 | 15.1 | 5.4 | 2.2 | 3.0 | 1.3 | 0.5 | 2.7 | 8.1 |
| | 1980/1 | 16.9 | 14.0 | 2.5 | 11.3 | 4.4 | 1.0 | 5.1 | 0.4 | 0.7 | 2.9 | 6.0 | 22.9 | 14.5 | 5.5 | 2.1 | 1.9 | 1.0 | 0.6 | 3.3 | 8.4 |
| | 1981/2 | 16.0 | 13.3 | 2.6 | 10.5 | 4.2 | 1.0 | 4.7 | 0.6 | 0.7 | 2.8 | 5.9 | 21.9 | 13.7 | 5.7 | 2.4 | 0.8 | 1.1 | 0.8 | 3.0 | 8.2 |
| | 1982/3 | 16.2 | 13.5 | 2.4 | 10.9 | 4.3 | 1.0 | 5.1 | 0.8 | 0.6 | 2.8 | 7.7 | 23.9 | 15.8 | 6.4 | 3.1 | 0.8 | 1.1 | 0.6 | 4.0 | 8.1 |
| | 1983/4 | 16.1 | 12.8 | 2.1 | 11.7 | 3.8 | 1.1 | 5.1 | 1.1 | 0.6 | 3.3 | 7.7 | 23.8 | 17.1 | 6.4 | 3.4 | 1.1 | 1.4 | 0.7 | 4.2 | 6.7 |
| | 1984/5 | 16.4 | 13.0 | 1.9 | 10.9 | 3.3 | 1.0 | 4.9 | 1.1 | 0.6 | 3.4 | 8.3 | 24.7 | 17.7 | 6.7 | 3.5 | 1.1 | 1.4 | 2.2 | 2.7 | 7.0 |
| | 1985/6 | 17.5 | 14.1 | 1.9 | 12.1 | 3.0 | 1.0 | 5.7 | 1.8 | 0.6 | 3.4 | 8.7 | 26.1 | 18.4 | 6.9 | 3.8 | 1.1 | 1.4 | 2.4 | 2.7 | 7.7 |
| | 1986/7 | 18.1 | 14.5 | 1.8 | 11.9 | 2.7 | 1.0 | 5.4 | 2.3 | 0.5 | 3.7 | 8.5 | 26.6 | 20.3 | 7.2 | 4.2 | 1.0 | 1.8 | 2.7 | 3.4 | 6.3 |
| | 1987/8 | 17.3 | 13.8 | 1.7 | 12.0 | 2.6 | 1.3 | 5.6 | 1.9 | 0.6 | 3.5 | 9.4 | 26.7 | 19.8 | 7.0 | 4.9 | 1.2 | 1.3 | 2.6 | 2.9 | 6.9 |
| | 1988/9 | 18.1 | 14.3 | 1.7 | 12.4 | 2.6 | 1.9 | 5.5 | 1.9 | 0.5 | 3.7 | 8.1 | 26.1 | 19.9 | 6.6 | 5.0 | 1.7 | 1.3 | 2.5 | 2.7 | 6.3 |
| | 1989/90 | 18.6 | 14.0 | 1.7 | 12.1 | 2.7 | 1.8 | 5.9 | 1.1 | 0.5 | 4.6 | 7.3 | 25.9 | 19.3 | 6.9 | 5.5 | 1.1 | 1.4 | 2.4 | 2.2 | 6.5 |
| | 1990/1 | 16.1 | 12.7 | 1.9 | 10.7 | 2.5 | 1.7 | 5.0 | 1.2 | 0.4 | 3.4 | 9.5 | 25.6 | 19.2 | 6.3 | 4.9 | 1.0 | 1.3 | 2.8 | 2.8 | 6.4 |
| | 1991/2 | 18.1 | 13.6 | 2.1 | 11.1 | 2.5 | 1.7 | 5.1 | 1.2 | 0.5 | 4.6 | 8.4 | 26.5 | 19.0 | 6.3 | 5.2 | 0.7 | 1.5 | 3.8 | 1.7 | 7.5 |
| | 1992/3 | 17.9 | 13.3 | 2.6 | 10.5 | 2.7 | 1.8 | 4.7 | 0.9 | 0.4 | 4.6 | 8.1 | 26.0 | 20.3 | 6.5 | 5.9 | 0.5 | 1.5 | 4.1 | 1.8 | 5.7 |
| | 1993/4 | 17.2 | 13.2 | 2.6 | 10.4 | 2.2 | 1.9 | 4.1 | 1.7 | 0.5 | 4.0 | 6.0 | 23.2 | 18.7 | 5.8 | 5.8 | 0.3 | 1.6 | 3.6 | 1.5 | 4.5 |
| | 1994/5 | 16.9 | 13.7 | 3.4 | 10.3 | 2.4 | 2.3 | 4.1 | 1.1 | 0.5 | 3.2 | 5.9 | 22.8 | 18.4 | 5.6 | 5.2 | 0.3 | 1.8 | 3.7 | 1.8 | 4.4 |
| | 1995/6 | 17.2 | 14.3 | 3.7 | 10.5 | 2.4 | 2.3 | 4.2 | 1.2 | 0.5 | 2.9 | 7.0 | 24.2 | 19.8 | 5.6 | 6.2 | 0.5 | 2.2 | 3.5 | 1.8 | 4.4 |
| | 1996/7 | 15.6 | 13.2 | 3.5 | 9.7 | 2.3 | 2.3 | 3.5 | 1.1 | 0.5 | 2.4 | 6.4 | 22.0 | 18.5 | 5.2 | 6.6 | 0.5 | 1.9 | 3.0 | 1.4 | 3.5 |
| | 1997/8 | 16.0 | 13.2 | 3.9 | 9.3 | 2.3 | 2.0 | 2.8 | 1.6 | 0.6 | 2.8 | 7.6 | 23.7 | 19.8 | 5.1 | 7.6 | 0.3 | 2.3 | 3.2 | 1.4 | 3.9 |
| | 1998/9 | 16.3 | 14.1 | 3.9 | 10.2 | 2.1 | 2.5 | 2.2 | 2.7 | 0.6 | 2.3 | 6.0 | 22.4 | 19.0 | 4.9 | 7.7 | 0.7 | 2.2 | 2.8 | 0.7 | 3.4 |
| 1999/2000 | 16.4 | 13.3 | 4.0 | 9.3 | 2.0 | 3.4 | 2.2 | 1.2 | 0.6 | 3.1 | 5.8 | 22.2 | 19.0 | 4.5 | 7.7 | 0.8 | 2.1 | 3.2 | 0.8 | 3.2 | |

Table 7
Poverty trends in Pakistan, Headcount

| Years | Overall Pakistan | Rural | Urban |
|---------|------------------|-------|-------|
| 1963-64 | 40.24 | 38.94 | 44.53 |
| 1966-67 | 44.50 | 45.62 | 40.96 |
| 1969-70 | 46.50 | 49.11 | 38.76 |
| 1979 | 30.68 | 32.51 | 25.94 |
| 1984-85 | 24.47 | 25.87 | 21.17 |
| 1987-88 | 17.32 | 18.32 | 14.99 |
| 1990-91 | 22.11 | 23.59 | 18.64 |
| 1992-93 | 22.40 | 23.35 | 15.50 |
| 1996-97 | 31.00 | 32.00 | 27.00 |
| 1998-99 | 32.60 | 34.80 | 25.90 |

Source: Amjad and Kemal (1997); Qureshi and Arif (1999).

Tariff reduction as part of IMF adjustment programmes has not only adversely affected the large-scale manufacturing sector, but has also resulted in a considerable loss of government revenue. Revenue from custom duty declined sharply from 5.9 per cent of GDP in 1989/90 to 2.2 per cent in 1998/9, increasing the country's reliance on revenue from domestic taxes such as general sales tax (Table 6). However, the revenue increase achieved through sales tax was not sufficient to compensate for the trade taxes lost over the period. The loss of revenue from trade taxes subsequently forced the government, in order to finance the fiscal deficit, to borrow further from domestic and external sources. Consequently, the ratio of domestic debt to GDP rose from 43 per cent in 1988/9 to 49 per cent in 1999/2000. The deteriorating resource position forced the government towards short-term borrowing from external sources. These developments, together with persistent devaluation of domestic currency, worsened the external debt-to-GDP ratio. External debt as per cent of GDP increased rapidly from 34 per cent in 1990/1 to 52.6 per cent in 1998/9. Consequently, the rapid growth of both internal and external debt resulted in a high debt servicing ratio—87 per cent of total tax revenue, or 7.7 per cent of GDP in 1998/9 (Table 6).

The government was initially able to reduce the budget deficit by 2 percentage points of GDP in 1993/4. But stabilization was short-lived. Major slips in policy implementation occurred in the form of a proliferation of tax exemptions and concessions leading to the implementation of further stabilization measures in the next financial year. Repeated attempts to stabilize the economy in the 1990s without the accompanying structural reforms pushed the economy in a vicious circle. Although the government resorted to raising taxes in an effort to reduce the budget deficit, increased tax rates on shrinking tax base led to a further decrease of the taxbase through tax evasion and an expansion of the underground economy. The stagnant tax-to-GDP ratio, together with rising debt servicing, resulted in a cut in development expenditure to reduce the budget deficit. Thus, development expenditure declined persistently throughout the reform period, adversely affecting economic growth rate and inducing higher unemployment and poverty levels (Tables 7 and 8). The poverty level is almost doubled⁴ over the past ten years. The country now spends on debt servicing more than twice the amount earmarked for development and the social sector. Without a doubt, the country is in a debt trap. High debt servicing has resulted in lower investment and growth which, in turn, has

⁴ For details see Anwar (2001).

Table 8
Macroeconomic indicators, 1970/1-1999/2000

| | Annual growth rates | | | | | | | | | |
|------------------|---------------------|-------------|---------------|---------------------------|----------|-------------------|---------------|----------------|-------------|-------------------|
| | Real GDP | Agriculture | Manufacturing | Large-scale manufacturing | Services | Per capita income | CPI inflation | Budget deficit | C/A deficit | Unemployment rate |
| | | | | | | | | As % of GDP | | % |
| 1970/1 | 1.2 | -3.1 | 6.4 | 6.2 | 4.9 | | 5.7 | - | 6.7 | 1.7 |
| 1971/2 | 2.3 | 3.5 | 1.2 | -0.5 | 5.1 | -0.2 | 4.7 | - | 3.8 | 2.0 |
| 1972/3 | 6.8 | 1.7 | 8.7 | 9.2 | 5.2 | 3.0 | 9.7 | 3.6 | 1.1 | 1.9 |
| 1973/4 | 7.5 | 4.2 | 6.4 | 6.1 | 5.4 | 4.2 | 30.0 | 5.2 | 5.4 | 1.8 |
| 1974/5 | 3.9 | -2.1 | 0.5 | -1.6 | 5.7 | 0.9 | 26.7 | 9.3 | 9.4 | 1.7 |
| 1975/6 | 3.3 | 4.5 | 1.4 | -0.6 | 5.7 | 1.4 | 11.7 | 9.5 | 6.2 | 2.2 |
| 1976/7 | 2.8 | 2.5 | 1.8 | -0.2 | 3.2 | 1.0 | 9.2 | 8.5 | 5.9 | 2.6 |
| 1977/8 | 7.7 | 2.8 | 10.2 | 10.9 | 8.5 | 7.3 | 6.9 | 7.8 | 2.7 | 3.1 |
| 1978/9 | 5.5 | 3.1 | 8.0 | 7.9 | 5.8 | 2.9 | 11.2 | 8.8 | 5.0 | 3.6 |
| 1979/0 | 7.3 | 6.6 | 10.3 | 11.0 | 5.7 | 4.0 | 11.2 | 6.8 | 3.7 | 3.6 |
| 1980/1 | 6.4 | 3.7 | 10.6 | 11.5 | 6.6 | 2.2 | 13.9 | 6.0 | 2.8 | 3.7 |
| 1981/2 | 7.6 | 4.7 | 13.8 | 15.7 | 7.9 | 2.9 | 11.1 | 5.9 | 3.4 | 3.8 |
| 1982/ | 6.8 | 4.4 | 7.0 | 6.6 | 9.2 | 6.2 | 4.7 | 7.7 | 0.6 | 3.9 |
| 1983/4 | 4.0 | -4.8 | 7.9 | 7.7 | 7.6 | 1.1 | 7.3 | 7.7 | 2.2 | 3.9 |
| 1984/5 | 8.7 | 10.9 | 8.1 | 8.0 | 8.2 | 3.0 | 5.7 | 8.3 | 4.1 | 3.7 |
| 1985/6 | 6.4 | 6.0 | 7.6 | 7.3 | 5.8 | 2.5 | 4.4 | 8.7 | 2.4 | 3.6 |
| 1986/7 | 5.8 | 3.3 | 7.5 | 7.2 | 5.9 | 1.6 | 3.6 | 8.5 | 1.0 | 3.1 |
| 1987/8 | 6.4 | 2.7 | 10.0 | 10.6 | 6.8 | 1.6 | 6.3 | 9.4 | 3.1 | 3.1 |
| 1988/9 | 4.8 | 6.9 | 4.0 | 2.4 | 3.8 | 1.4 | 10.4 | 8.1 | 3.4 | 3.1 |
| 1989/90 | 4.6 | 3.0 | 5.7 | 4.7 | 4.5 | 1.6 | 6.0 | 7.3 | 3.4 | 3.1 |
| 1990/1 | 5.6 | 5.0 | 6.2 | 5.4 | 5.2 | 4.6 | 12.7 | 9.5 | 3.0 | 6.2 |
| 1991/2 | 7.7 | 9.5 | 8.1 | 7.9 | 6.8 | 4.1 | 10.6 | 8.4 | 1.9 | 5.9 |
| 1992/3 | 2.3 | -5.3 | 5.4 | 4.1 | 4.6 | -0.8 | 9.8 | 8.1 | 6.4 | 4.7 |
| 1993/4 | 4.5 | 5.2 | 5.5 | 4.3 | 4.2 | 0.9 | 11.3 | 6.0 | 3.2 | 4.8 |
| 1994/5 | 5.3 | 6.6 | 3.6 | 1.5 | 4.8 | 3.0 | 13.0 | 5.9 | 3.5 | 5.4 |
| 1995/6 | 6.8 | 11.7 | 4.8 | 3.1 | 5.0 | 1.5 | 10.8 | 7.0 | 6.8 | 5.4 |
| 1996/7 | 1.9 | 0.1 | 1.3 | -2.1 | 3.6 | -1.6 | 11.8 | 6.4 | 5.6 | 6.1 |
| 1997/8 | 4.3 | 3.8 | -1.6 | 7.6 | 3.2 | -1.4 | 7.8 | 7.6 | 2.7 | 6.1 |
| 1998/9 | 3.2 | 2.0 | 4.2 | 3.7 | 4.1 | 0.4 | 5.7 | 6.0 | 2.6 | 6.1 |
| 1999/2000 | 4.5 | 5.5 | 1.6 | 0.0 | 4.5 | 2.8 | 3.4 | 5.8 | 2.3 | 6.1 |
| Decade averages: | | | | | | | | | | |
| 1970s | 4.8 | 2.4 | 5.5 | 4.8 | 5.5 | 2.7 | 12.7 | 7.4 | 5.0 | 2.4 |
| 1980s | 6.1 | 4.1 | 8.2 | 8.2 | 6.6 | 2.4 | 7.3 | 7.8 | 2.6 | 3.5 |
| 1990s | 4.6 | 4.4 | 3.9 | 3.6 | 4.6 | 1.4 | 9.7 | 7.1 | 3.8 | 5.7 |
| 1988-2000 | 4.6 | 4.5 | 4.1 | 3.6 | 4.5 | 1.4 | 9.4 | 7.2 | 3.7 | 5.3 |

Source: Government of Pakistan (2000).

limited the capacity to service debt, forcing a further rescheduling of external debt in 2001. The above adverse outcome is reflection of the fact that the country adapted import liberalization very rapidly. Maximum tariff rates were reduced from 225 per cent to 70 per cent within a relatively short period of time to meet the IMF conditionalities, while largely ignoring the adverse effects. With the country's high protection levels, the

cost of adjustment was considerable in terms of loss of output and employment compared to the benefits gained through trade liberalization.

On the whole, policy failure was caused mainly by neglecting the consequences of financing large current account deficits on the long-term balance of payment. The real problem, however, was associated with poor economic management, excessive reliance on the external resources used to finance consumption rather than investment, neglect of domestic saving, and ineffective use of borrowed resources. In addition, reliance on foreign savings further deepened as a consequence of the IMF/World Bank adjustment programmes in the 1990s. As a result, the saving investment gap was higher in 1990s than the 1980s (Table 9). Thus, the debt crisis was inevitable, given the large current account deficit and the growing need to finance imports through external resources.

Table 9
Savings-investment gap

| Years | Savings | Investment | S-I Gap | Savings | Investment | S-I Gap |
|---------|-------------------------|------------|----------|-------------|------------|---------|
| | (in millions of rupees) | | | As % of GDP | | |
| 1972/3 | 7,213 | 8,647 | -1,434 | 10.7 | 12.8 | -2.1 |
| 1973/4 | 6,179 | 11,614 | -5,435 | 7.0 | 13.2 | -6.2 |
| 1974/5 | 6,655 | 18,218 | -11,563 | 6.0 | 16.4 | -10.4 |
| 1975/6 | 14,672 | 24,057 | -9,385 | 11.3 | 18.5 | -7.2 |
| 1976/7 | 18,451 | 28,856 | -10,405 | 12.3 | 19.3 | -6.9 |
| 1977/8 | 25,525 | 31,505 | -5,980 | 14.5 | 17.9 | -3.4 |
| 1978/9 | 23,847 | 34,876 | -11,029 | 12.9 | 18.9 | -6.0 |
| 1979/80 | 32,060 | 43,345 | -11,285 | 13.7 | 18.5 | -4.8 |
| 1980/1 | 42,070 | 52,207 | -10,137 | 15.1 | 18.8 | -3.6 |
| 1981/2 | 46,254 | 62,447 | -16,193 | 14.3 | 19.3 | -5.0 |
| 1982/3 | 61,947 | 68,462 | -6,515 | 17.0 | 18.8 | -1.8 |
| 1983/4 | 63,220 | 76,701 | -13,481 | 15.1 | 18.3 | -3.2 |
| 1984/5 | 61,056 | 86,525 | -25,469 | 12.9 | 18.3 | -5.4 |
| 1985/6 | 76,608 | 96,545 | -19,937 | 14.9 | 18.8 | -3.9 |
| 1986/7 | 97,195 | 109,540 | -12,345 | 17.0 | 19.1 | -2.2 |
| 1987/8 | 92,062 | 121,666 | -29,604 | 13.6 | 18.0 | -4.4 |
| 1988/9 | 108,398 | 145,570 | -37,172 | 14.1 | 18.9 | -4.8 |
| 1989/90 | 121,514 | 162,076 | -40,562 | 14.2 | 18.9 | -4.7 |
| 1990/1 | 144,773 | 193,447 | -48,674 | 14.2 | 19.0 | -4.8 |
| 1991/2 | 206,809 | 244,059 | -37,250 | 17.1 | 20.1 | -3.1 |
| 1992/3 | 182,004 | 277,744 | -95,740 | 13.6 | 20.7 | -7.1 |
| 1993/4 | 246,205 | 305,477 | -59,272 | 15.7 | 19.4 | -3.8 |
| 1994/5 | 269,872 | 346,508 | -76,636 | 14.3 | 18.4 | -4.1 |
| 1995/6 | 249,842 | 403,417 | -153,575 | 11.7 | 18.8 | -7.2 |
| 1996/7 | 286,074 | 436,043 | -149,969 | 11.6 | 17.7 | -6.1 |
| 1997/8 | 385,029 | 468,008 | -82,979 | 14.1 | 17.1 | -3.0 |
| 1998/9 | 363,588 | 446,872 | -83,284 | 12.0 | 14.8 | -2.8 |

Source: Government of Pakistan (2000).

5 Reviving economic growth and reducing debt burden

In designing a debt reduction strategy, it should be kept in mind that the plan can be successful only if the fundamental causes that triggering the debt build-up, and subsequent lower growth rate and higher poverty level have been addressed properly. These fundamental causes include financing of substantial current account deficits and persistent devaluation of domestic currency in the 1990s, weak macroeconomic management, inconsistent implementation of policy reforms and poor governance, as well as external factors such as worsening terms of trade. Thus, there is a need to adopt an integrated approach that focuses on recovery of economic growth, poverty reduction, and reduction in stock of debt as well as the debt servicing. The broad policy framework for the revival of economic growth and poverty reduction should consist of the following aspects: (i) macroeconomic policies, including monetary, fiscal and exchange rates policies which, with timely adjustment in the face of economic shocks, provide a stable environment for economic activity; (ii) structural policies, including trade, tax and sector policies and regulatory environments which affect incentives for private investment and production; (iii) public sector management, whereby public sector institutions provide services complementary to private initiatives such as infrastructure and social services; (iv) governance and market institution, including the rule of law and reduction of corruption, and (v) social inclusion, which emphasizes full participation of the society through social services that reach the poor.

For effective debt management, fiscal consolidation—including tax reform to strengthen the fiscal payments capacity—is essential in achieving debt sustainability. Prudent budgeting and reorienting of expenditures from nonproductive to growth-enhancing activities within a medium-term framework are important to achieve a fiscal sustainable fiscal position.

The design of trade policy reforms is also an important factor in performance failure. Trade liberalization should not be pursued rapidly as an end onto itself. The previous section shows that the fast lowering of tariffs as a component of IMF adjustment programmes has not only resulted in a considerable loss of revenue, but has also adversely affected large-scale manufacturing sector. As Pakistan's experience shows, if carried out in such a manner that the country is not ready or able to cope, or that it faces unfavourable conditions, trade liberalization can contribute to a vicious cycle of trade and balance of payment deficits, financial instability, debt and recession.

The failure of the WTO's Seattle Round has changed the perception of and attitude towards liberalization. Developing countries were generally discontented about their non-benefits from the conclusion of Uruguay Round and the WTO agreements. The main problems include (i) tariff peaks remaining in effect in the rich countries for many industrial products exported by the developing countries; (ii) no gains having been achieved as yet from the supposed phasing out of the textiles quotas; (iii) increase in non-tariff barriers such as anti-dumping measures in the developed countries; (iv) continued high protection in agriculture in rich countries; (v) implementation problems of Uruguay Round and developing countries concerns related to the negative effects of the Agriculture, TRIM and TRIPS agreements. Many developing countries argued that some of the rules are imbalance and inequitable, generating problems and, therefore, need to be reviewed. Trade policy should take an account of the weaknesses of the various agreements and an assessment should be carried out before implementation to determine how the economy would be affected by the trade reforms.

However, one of the fundamental causes of stagnating exports is the worsening terms of trade. The economy is dependent on a very narrow production and export base with three main items—textile yarn and fibre, clothing, cereal and cereal-based products. These account for more than 70 per cent of exports. Such a narrow export base creates exceptional vulnerability to external shocks, one of the main reasons for lower export earnings over the last decade. Diversification of the export base is essential to avoid terms of trade shocks.

6 Enhanced HIPC Initiatives and Pakistan's eligibility

Many poor countries, similarly to Pakistan, also faced increasing difficulty in making payments on their debts in the 1980s and 1990s following the structural adjustment programmes within the framework of IMF and the World Bank. Besides domestic factors such as high fiscal and current account deficits and low saving rate, external factors—oil price shocks, high interest rates, recession in the industrial countries, and weak commodity prices—were major factors contributing to the debt build-up. Despite debt rescheduling exercises, new official assistance, and policy package, the debt of the poor countries remains high. To provide a comprehensive solution to this heavy indebtedness, the IMF and the World Bank announced the HIPC Initiative in 1996.

The Initiative is aimed at making poor countries' debt service burdens manageable through a combination of sound policies, generous debt relief, and new inflows of aid. Eligibility for receiving debt relief is limited to those countries that are eligible for ID loans, have established strong track records of performance under programmes supported by the IMF and the World Bank, and those that are not expected to achieve external debt sustainability even after the full use of traditional debt-relief mechanisms (such as the Paris Club's Naples Terms).

A key indicator of external debt sustainability used in the Initiative is the ratio of the net present value (NPV) of debt to exports. Until the fall of 1999, assistance was provided to bring the NPV of debt after traditional mechanisms within the range of 200 to 250 per cent of exports. The target NPV debt-to-export ratio within this range for a qualifying country was determined using country-specific vulnerability factors. These include the concentration and variability of export earnings, the fiscal burden of external debt service, external debt in relation to GDP, the resource gap, level of international reserves, and the burden of private sector debt.

But progress under the HIPC Initiative did not meet expectations. The Initiative was, therefore, enhanced in October 1999 to include a reduction of targets and thresholds; modified performance requirements, and a strengthening of the link between debt relief and poverty reduction. The modified thresholds are 150 per cent of NPV of the debt-to-exports ratio and a debt service ratio of 15-20 per cent. For very open economies (with openness measured as 30 per cent of exports to GDP and fiscal indicator as 15 per cent revenue to GDP), the fiscal window of the threshold was lowered from 280 per cent to 250 per cent of NPV of debt to revenue.

Amongst the heavily indebted countries, 22 HIPCs have already reached their decision points. The enhanced HIPC Initiative would bring down the NPV of debt-to-exports ratio of these countries from 260 per cent in 1999 to 126 per cent in 2003, below the

average (128) for all non-HIPC developing countries and well below the critical threshold of 150 per cent that caused the sharp increase in the incidence of debt rescheduling in the past. The average terms of debt will be more favorable and, in coming years, eligible HIPCs are expected to have their debt service-to-exports ratios reduced to less than half that of the developing countries in general. Combined with traditional relief and likely additional bilateral debt forgiveness, the HIPCs Initiative is expected to reduce the debt stock of these countries by almost two-thirds from US\$ 53 billion in net present value terms to about US\$ 20 billion. It seems that the HIPCs are likely to benefit greatly from enhanced HIPCs Initiative and thus would resolve their debt problems within a relatively short period of time.

As indicated in the previous section, Pakistan's external debt in 1998 both as per cent of GNP and of exports was significantly higher than all but the heavily poor indebted countries. Compared to all country groups, Pakistan's debt service problem is more severe and its total debt service as per cent of exports is considerably higher than all other countries, including the heavily indebted countries. In this situation, it is important to explore the country's prospects for debt relief under the enhanced HIPC Initiative.

Pakistan's net present value of external debt as per cent of exports is 230 per cent, while the debt service-to-export ratio is 24 per cent (Table 4). Both of these ratios are clearly above the external debt sustainability threshold of 150 per cent of NPV of the debt-to-export ratio and the debt service ratio of 15-20, defined under the enhanced HIPC Initiative. Thus, according to this criteria, the country qualifies for assistance under the Initiative.

Other criteria are (i) the adoption of a poverty reduction strategy paper (PRSP) through a broad-based participatory process by the decision point; and (ii) good progress in implementing this strategy for at least one year by completion point. In this context, Pakistan has already launched a poverty reduction programme in the year 2000, which will increase economic opportunities for the poor, ensure their empowerment and access to physical and social assets leading to welfare improvement. In contrast to the approaches adopted in past when poverty reduction was considered as a by-product of the growth process, the country undertook a major policy shift to bring it to centre stage of economic policymaking. Under this approach, direct anti-poverty programmes have been integrated in the macroeconomic framework. The focus is on small public works in the poorest low-income urban and rural areas where these are expected to have a greater impact on poverty. In the poorest rural areas the programme includes the development of farm-to-market roads, de-silting of canals, construction of ponds and soil conservation. In the poorest urban areas, schemes for improving water supply and sewerage, and garbage collection and disposal are to be included. This will generate significant employment for the poor and have a positive effect on their income and living standards. The government has also scaled up the food support programme to five times the size of its earlier version. Under the programme, 1.26 million poor households with income less than Rs 2,000 per month will receive Rs 2,000 per annum to buy wheat flour.

In August 2000, the government also announced its to establish a micro-finance bank to enhance the access of the country's millions of poor to credit for income generation and employment promotion. The bank would operate on non-profit and cost-recovery basis, and plans to extend credit ranging from Rs 5,000 to Rs 30,000 to around 100,000 poor

persons in the small communities by December 2001. Overall, the lending programme will cover 30 per cent women and beneficiaries will directly get the loans.

However, even though the government is making an effort at poverty reduction, the challenge of meeting external financing remains. Exceptional assistance from IMF, World Bank and bilateral donors, privatization receipts and non-interest current account surpluses will be needed to meet debt service payments and to increase foreign exchange reserve to satisfactory levels. The government's debt management committee has estimated the resources required to meet external financing for the period July 2000-June 2004 (Table 10). In contrast to the 1990s, when the country maintained average annual resource deficits of US\$ 1.5 billion or 3 per cent of GDP, it will have to generate an annual of about US\$ 1 billion in the non-interest current account balance of payments over 2000-04 or 1.5 per cent of GDP. This will need a major export expansion and considerable import saving. Furthermore, efforts are required to bring in at least US\$ 3 billion from privatization sales to foreigners. In addition, the country will need US\$ 6 billion in exceptional assistance from the IMF (mainly under poverty reduction and growth facility [PRGF]), World Bank and ADB and debt rescheduling totaling about US\$ 5 billion. If these flows do not materialize, the country will not be able to meet its debt obligations. However, the country should explore debt relief under the enhanced HIPC's Initiative, which provides more favourable terms than debt rescheduling, as the grant element is high in this assistance.

Currently, an IMF standby arrangement, which ends September 2001, is in effect in Pakistan. Most criteria on key performance stipulated by the programme have largely been met, and the country is planning to start negotiations for assistance under PRGF. If the negotiations are successful, the country should seek debt relief under HIPC's Initiative, which would bring down Pakistan's NPV of debt-to-exports ratio from 230 per cent to 150 per cent, the external debt sustainability threshold, within the next three years. Assuming a constant growth rate of NPV of debt and exports, it can be simulated that the country will qualify for assistance totalling about US\$ 6.6 billion under the HIPC's Initiative. Thus, the country could reduce its debt burden to a sustainable level within a relatively short period of time.

Table 10
Illustrative scenario of the sources and uses of foreign exchange
July 2000-June 2004
(in billions of US\$)

| Sources | | Uses | |
|---|------|------------------------------------|------|
| Non-Interest current account surplus | 3.8 | Debt service payments | 20.6 |
| Normal disbursement of medium- and long-term loans | 6.2 | | |
| Net foreign private investment | 2.5 | Increase foreign exchange reserves | 3.8 |
| Rescheduling from Paris Club and non-consortium debt countries | 5.1 | | |
| Privatization proceeds | 3 | | |
| Exceptional quick disbursing assistance from IMF/World Bank/ADB | 6 | | |
| Trade finance | 0.3 | | |
| Least possible shortfalls | -2.3 | | |
| Total | 24.4 | | 24.4 |

Source: Government of Pakistan (2001).

7 Concluding remarks

The paper examined the gravity of the debt problem in Pakistan. The heavily reliance on foreign resources, especially on short-term loans following the structural adjustment programmes within the framework of the IMF and the World Bank in the 1990s, has contributed to the external financial vulnerability, debt, and recession that precipitated debt rescheduling in 1998/9. The IMF frequently demanded the devaluation of the domestic currency against the US dollar to enhance exports over the last decade. While exports remained stagnant, mainly due to weak commodity prices and non-availability of exportable surplus, the devaluation of the rupee against the US dollar has directly added to the rupee value of foreign debt, causing the dramatic increase in debt service burden. This, in turn, has crowded out development expenditure and resulted in lower economic growth and higher poverty levels. Thus, devaluation as an instrument for export promotion involves substantial costs while its benefits are uncertain. The experience of Pakistan suggests that if trade liberalization is carried out in such a manner that a country is not ready or able to cope, or faces conditions that are unfavorable, liberalization can contribute to financial instability and debt and recession. Before liberalizing the trade regime, it is important to examine the quality, timing, sequencing and scope of liberalization (especially import liberalization), and whether the process is accompanied by other factors such as the strengthening of local enterprises and farms, human resource and technological development as well as the build-up of export capacity and markets.

The analysis suggests that there was a policy failure triggered mainly by the neglect of the consequences of large current account deficits. Not only the government, but also the IMF and the World Bank were too optimistic with regard to export promotion through the rapid opening-up of the trade regime and the frequent use of devaluation as an instrument to enhance export competitiveness. Thus, the blame should be shared equally and compensation be made in the form of debt forgiveness and debt relief on highly concessional terms.

In designing a debt reduction strategy, it is imperative to address the fundamental causes that triggered the debt build-up, and the subsequent adverse effects on economic growth and poverty levels. There is need to adopt an integrated approach that focuses on the recovery of economic growth, poverty reduction, and reduction in stock of debt as well as the debt servicing. For effective debt management, fiscal consolidation, which also includes tax reform to strengthen the fiscal payments capacity, is essential in achieving debt sustainability. Attention should also be given to eliminating the dependency on a very narrow production and export base. Diversification of the exports is the best insurance against terms of trade shocks.

Pakistan's external debt service problem is more severe as compared to all other countries, including the HIPC's, thus reflecting the gravity of country's debt crisis. Although the country qualifies for assistance under the enhanced HIPC Initiative, given its ratio of NPV of debt to exports, it has to adopt the poverty reduction strategy paper to comply with the eligibility criteria for HIPC debt relief. The requirement of adopting a PRSP involves long, complex and comprehensive planning; debt reduction, on the other hand, is urgently needed to free up resources to meet the basic needs of the poor. These two processes should be made parallel so as to provide immediate debt relief to countries like Pakistan whose debt problems are much more severe than the HIPC countries. Countries, like Pakistan, with viable poverty reduction strategies should be

entitled to immediate debt relief. The eligibility criteria for debt relief should be shifted away from the traditional emphasis on balance of payments indicators and other financial criteria towards greater emphasis on the use of social performance indicators.

Pakistan is pursuing a poverty reduction programme, which can gain further momentum if foreign assistance on concessional terms is made available. The availability and efficient use of foreign resources, in addition to the terms and conditions under which the foreign financing is obtained, are crucial to maintain a sustainable debt situation for growth prospects and poverty reduction in Pakistan.

Foreign direct investment is one of the important sources of additional finance. However, despite strong need for private sector inflows, the country has not been able to attract foreign investors in the past. The challenge for Pakistan is to establish a climate favourable to private investors—both for domestic and foreign. But even with strong private sector growth, a sizable part of development expenditure will remain to be financed externally by the government. To secure the financing needed for development and poverty reduction, concerted efforts are required from the creditors and donors as well as the government. Finally, the paper does not argue against debt rescheduling, but that alternatives should be explored in order to achieve external debt sustainability with faster and deeper debt reduction along with the revival of economic growth and poverty reduction in Pakistan.

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